APPENDIX E

Incorporated

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PAUL RODGERS
Administrative Director
General Counsel

GAILE ARGIRO
Treasurer

April 10, 1992

Mr. Sam Ginn
Chairman of the Board, President,
and Chief Executive Officer
Pacific Telesis
130 Kearny Street
San Francisco, CA 94108

Dear Mr. Ginn:

This is to inform you that the joint NARUC/FCC audit team is assembled, has reviewed recent utility regulatory audit activity of Pacific Telesis for applicability or duplication of effort, has accordingly customized an audit scope and is now ready to start its audit of your company. The purpose of this letter is to provide you this additional information regarding the objectives, scope, conduct and other audit arrangements for your planning purposes.

BACKGROUND

By letter dated, December 20, 1991 NARUC President, Kenneth Gordon, formally transmitted the NARUC resolution regarding an audit of the affiliated transactions of the seven Regional Bell Operating Companies and solicited your cooperation. At the NARUC meetings held in Washington, D.C. last month, additional information regarding the scope and other audit details were provided and discussed. As you know, these were open meetings and they were well attended by all interested parties.

AUDIT OBJECTIVES

The auditors will be guided by the following audit objectives as set forth in the resolution:

PROJECT DELIVERABLES

The audit reports will contain adequate documentation or analysis to support the conclusions reached. The reports will also set forth the approach or methodology followed in forming the conclusions and in developing the recommendations. There will be an audit report for each of the seven RBOCs.

RELEASE OF THE AUDIT REPORTS

The RBOCs will be provided with a draft copy of the audit report and will have fifteen days to review and submit comments on their respective final draft audit reports before NARUC release. The Chairman of the Staff Subcommittee on Accounts will transmit the audit reports to:

- the President of NARUC
- the FCC
- the Members of the Finance and Technology Committee
- the Commissioners' Policy Management Group
- the Chairman of the Communications Committee and his designee
- the General Counsel of NARUC

The FCC will likely release the audit reports to the public within a relatively short time, but only after a statutory review for confidential disclosure.

PROPRIETARY AGREEMENT

The auditors will follow the normal practice of their own commissions with respect to access and the signing of any proprietary agreement. The oversight committee suggests that the proprietary agreement be modeled after the 1984 Bellcore agreement. A proposed proprietary agreement is attached hereto.

AUDIT EXPENSES

As has been the case with previous NARUC audits, the RBOCs have been requested to fund the audit expenses, including travel. It is expected that most if not all expenses will be traveled related. The expense claims will be submitted on a timely basis with supporting documentation. It is expected that the claims will also be processed in a timely manner. The auditors will follow their respective States' rules and regulations governing travel and related expenses. Although not expected to be necessary, the auditors reserve the option of retaining outside consultants to assist in the audits. However, no consultants will be retained before discussion with your company.

PROPRIETARY AGREEMENT

In order to facilitate the review of Pacific Telesis by the NARUC's Audit Team, Pacific Telesis is not restricting the disclosure of proprietary information to members of the Audit Team. It is therefore, possible that there will be disclosed information and documents describing unannounced services, unpublished technology, or private internal business plans, which information and documents are proprietary.

With respect to all such information and documents identified as proprietary, the members of the Audit Team agree to use information and documents in connection with the present review of Pacific Telesis. Pacific Telesis agrees at the request of the Audit Team to delineate in any documents identified as proprietary that they will in good faith work together to permit such publication or disclosure without compromising the proprietary information, as, for example, by masking, excision, or rewriting.

Notwithstanding the above, the members of the Audit Team in connection with their NARUC audit functions may disclose any documents to their superiors or other Commission Staff personnel engaged with them in the preparation of their report which superiors or personnel will be similarly obligated not to further disclose such proprietary information.

The members of the Audit Team are under no obligation with respect to any proprietary information or documents that are subsequently made public by Pacific Telesis.

Dispute with respect to what information or documents are deemed proprietary may be settled by the State Commission(s) having jurisdiction or by a mutually acceptable party as appropriate.

None of the above provisions prohibit the use of proprietary information in developing adjustments for use in a jurisdictional rate case or investigation. Moreover, no restriction on the use of the audit reports is intended by this agreement.

This agreement shall be binding on the parties to this Agreement from the date of its execution and shall remain in effect for a period of ten (10) years after the release of the final NARUC report.

Pacific Telesis and the Audit Team members cause this Agreement to be signed by their duly authorized representatives this ____ day of ______, 1992.

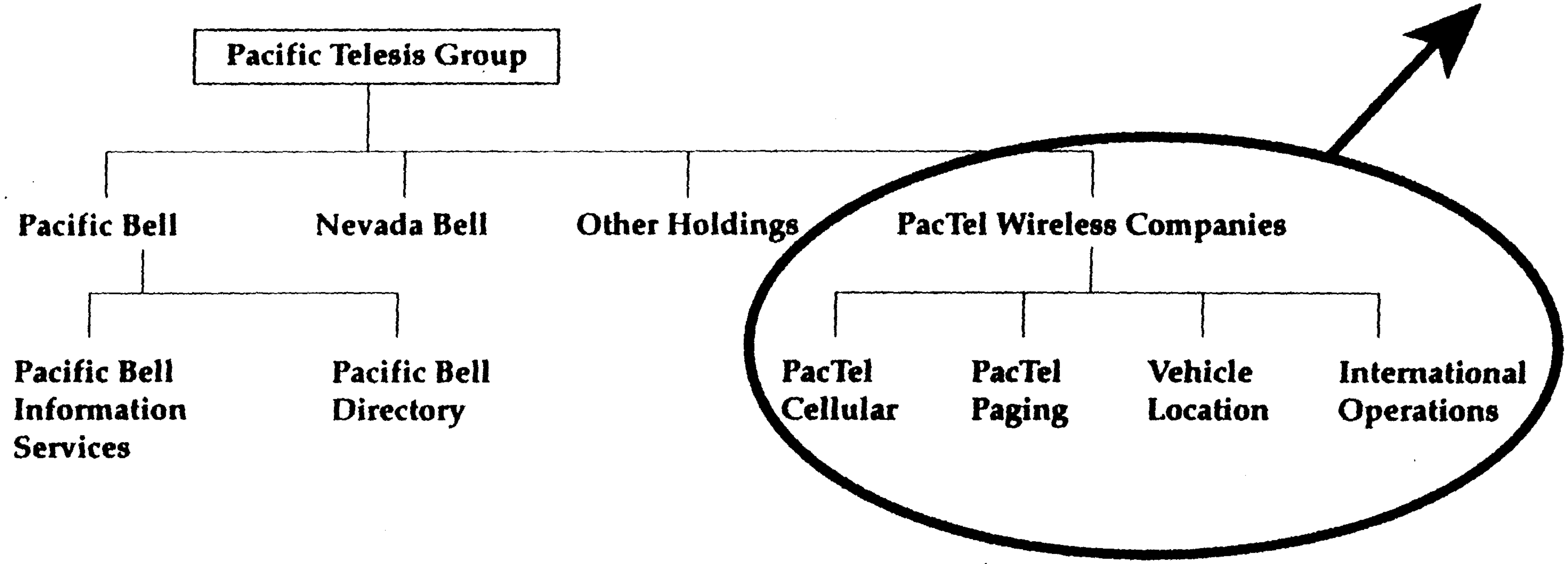
APPENDIX F

APPENDIX F

Pacific Telesis Group Spin-Off

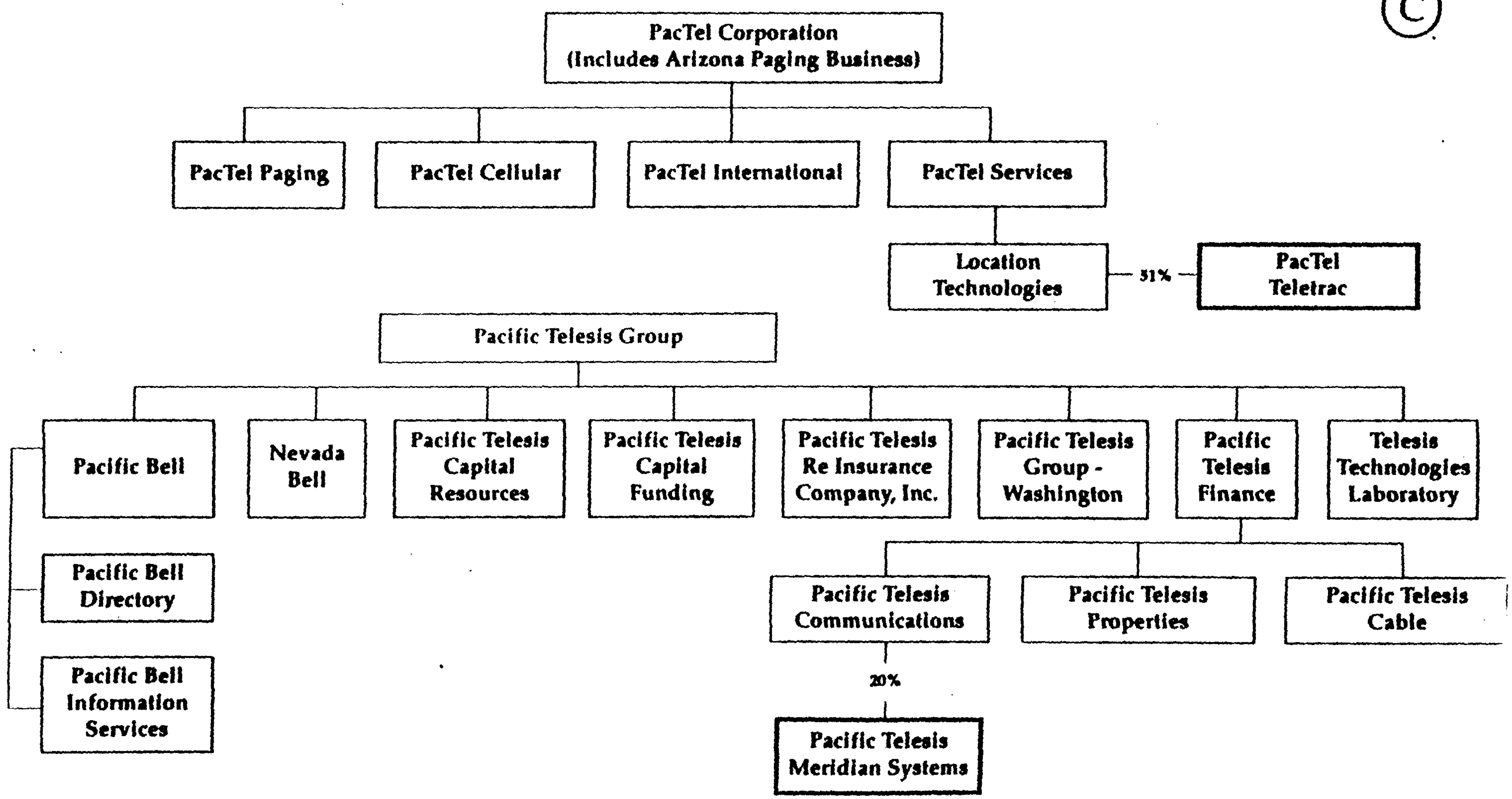
A

Pacific Telesis will spin off its wireless operations.



APPENDIX F

POST-SPIN-OFF STRUCTURE



APPENDIX G

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Pacific Telesis Center
130 Kearny Street, Suite 3001
San Francisco, California 94108
(415) 394-3200

APPENDIX G

PACIFIC TELESIS
Group

June 8, 1992

Mr. Tom Lew
Branch Chief - Telecommunications
Division of Ratepayer Advocates
California Public Utilities Commission
505 Van Ness Avenue, Room 4007
San Francisco, California 94102

Dear Tom:

The purpose of this letter is to confirm our verbal agreements in regard to the NARUC audit:

- *There will be only CPUC personnel conducting this audit. The CPUC will not share proprietary information with anyone outside the CPUC, and G.O. 66-C will be applicable.*

- *Prior to release of any material to non-CPUC personnel, Telesis will be afforded an adequate opportunity to review the material to ensure that no proprietary information was inadvertently included.*

- *If during the audit the CPUC desires to share some proprietary information with other NARUC personnel, they will obtain Pacific Telesis agreement before doing so. Pacific Telesis would be willing to work with the CPUC to develop specific non-disclosure agreements, develop alternative forms of information, or use other means to allow the CPUC to share specific information.*

We understand NARUC has proposed, for national use, a redrafted agreement protecting the RBOCs' proprietary information accessed during the NARUC audit. While we are considering the proposed agreement, pending a final agreement between NARUC and the RBOCs, G.O. 66-C will be followed for Telesis proprietary information.

In addition to the above agreements, we have attached our agreed upon access guidelines intended to facilitate open access to Telesis information and avoid misunderstandings. We recognize that these guidelines may need to be revised as the audit proceeds.

Tom, please let me know if you feel this doesn't faithfully represent our agreements, or if there are other changes that need to be made.

Sincerely,

Attachment

PART C

REPORT ON THE NARUC AUDIT OF PACIFIC BELL ELECTRONIC YELLOW PAGES

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CHAPTER 1

AUDIT OBJECTIVE, SCOPE, APPROACH, BACKGROUND, SUMMARY FINDINGS

AUDIT OBJECTIVE

The NARUC audit of Pacific Bell Yellow Pages began in November 1992. The NARUC Audit Team's objectives for the audit coincides with the NARUC resolution, outlined as follows:

- To determine if there was cross-subsidization of ratepayers resources to benefit telecos' shareholders;
- To determine if the future income potential of the Yellow Pages, which has provided significant benefits to ratepayers, are safeguarded; and
- To determine the propriety of the research and development efforts by Pacific Bell with respect to its yellow page business. To determine whether development of new products and services or modification of existing products and services are in the best interests of ratepayers.

AUDIT SCOPE

1. Research and review the state and federal regulations and the Modified Final Judgement as it pertains to yellow pages. This will encompass:

- History of legislative and regulatory enactment that affected the directory operation;
- Application of existing state and federal rules and existing regulations to the new yellow page products and services;
- Ramifications of business placement of new yellow page products and services under current state rules and regulations.

2. Investigate, review and research the product enhancement and development of Pacific Bell Directory. Emphasis will be placed on:

- Identifying all major product enhancement and development projects;

- Reviewing the process by which product enhancement and development took place;
- Reviewing the tracking and accountability of the projects; and
- Determining the propriety and reasonableness from the perspectives of the ratepayers' interest.

3. Research and analyze the potential impacts of the new developmental product(s) on ratepayers.

AUDIT APPROACH

The Audit Team focused on three areas:

1. The development process of the electronic yellow pages;
2. Pacific Telesis corporate involvement in the process;
3. Issues and concerns raised by electronic yellow pages.

The Audit Team issued data requests, interviewed project managers and key subject matter experts and reviewed thousands of pages of documents. The documents reviewed cover internal documents, electronic publishing/yellow pages industry research papers, journals, studies, and articles.

BACKGROUND

The Audit Team began its investigation of Pacific Bell Directory in late 1992. The Audit Team reviewed the yellow page operation, submitted data requests, and held interviews with management and subject matter experts. The Team's audit scope and approach focused on Pacific Bell Directory's major product development commonly referred to as electronic yellow pages.

By August 1993, Pacific Bell informed the Audit Team that Pacific Bell and Pacific Bell Information Services (PBIS), a Pacific Bell wholly owned subsidiary, was preparing to file an application requesting authorization for PBIS to develop and offer electronic publishing services and to account for associated revenues and expenses below-the-line for ratemaking purposes. The electronic publishing services will cover services such as electronic yellow pages and more. On December 23, 1993, Pacific Bell filed an application (A.93-11-031) which was accepted by the California Public Utilities Commission. The Commission's Division of Ratepayers Advocates, along with three other interested parties, filed protests. At the March 28, 1994 prehearing conference, th Administrative Law Judge ordered Pacific Bell to file testimonie on April 27, 1994, and all interested parties to file rebuttal testimonies on July 25, 1994. An evidentiary hearing is scheduled to be held on August 22, 1994.

The purpose of this report is to present the Audit Team's audit and analysis of Pacific Bell Directory's electronic yellow pages development.

SUMMARY FINDINGS AND CONCLUSIONS

1. The yellow page operations of Pacific Bell Directory, a wholly owned subsidiary of Pacific Bell, are considered to be part of the regulated rate base in California. All revenues and expenses associated with yellow page operations are thus considered "above-the-line" for ratemaking purposes, unless specifically excluded. This regulatory treatment started early in the corporate history of Pacific Bell (then known as Pacific Telephone and Telegraph Company) and continues to the present. All of the substantial contribution from the yellow page revenue streams is used to offset the cost of exchange operations.

2. Pacific Bell Directory's research and development and associated activities in electronic publishing and other emerging technology in the directory field were funded by the general body of ratepayers.

3. As best as can be determined, the ratepayers' funding of the these potential new electronic publishing services and products began in the mid-1980s, a period of over eight years.

4. A major impetus to this electronic publishing effort began when a key outside expert in the field of electronic publishing was hired by Pacific Bell Directory to lead the effort. The visionary strategy and direction of electronic publishing was provided by the former President of Pacific Bell Directory Company.

5. Substantial amount of staff resources at Pacific Bell Directory were involved in the research and development of potential electronic publishing services and products.

6. Numerous feasibility studies were made by outside consultants and by Pacific Bell Directory's own experts regarding the market potential for electronic yellow page publishing and other related line of businesses.

7. These studies generally show that the market potentials for the offering of electronic yellow publishing services and products by a RBOC are favorable.

8. The RBOCs are in a favorable competitive position in the emerging electronic yellow publishing because of the synergy from the companies' core telephone operations, namely, name recognition, established reputation, expertise in classified advertising, customer contacts and relationships, infrastructure, facilities, etc.

9. Over the mid- to long-term, electronic publishing will potentially offer serious competition to the traditional printed yellow pages. Unmitigated, substantial erosion of the present contribution from traditional printed yellow pages in the order of magnitude of millions of dollars will occur for Pacific Bell ratepayers.

10. All research and development activities were abruptly discontinued (about January 1993) at the Pacific Bell Directory. Key personnel and the electronic publishing activities were transferred to an essentially non-regulated subsidiary, Pacific Bell Information Services, a wholly owned subsidiary of Pacific Bell.

11. After about a year, a further transfer was made of this electronic publishing operation to a newly formed company that is not part of the Pacific Bell corporate structure, but is part of Pacific Telesis, the holding company.

12. The change in Pacific Bell corporate strategy to that of prohibiting Pacific Bell Directory from engaging in research and development, or from offering of electronic delivery or enhancement of the core yellow page information business have left the company with a mature business with a declining growth rate.

13. This strategy has removed from Pacific Bell Directory a potential new source of revenues to offset the potential loss of classified yellow page advertising revenues to emerging electronic publishing competitors and potentially to its newly formed affiliate company, the latter, being a form of cannibalization.

14. The Pacific Telesis Group's strategy, if unchanged, has left a billion dollar regulatory ratemaking asset without the means to enhance in a significant way or even to maintain its industry position over the long-term.

15. This change in Pacific Telesis' corporate strategy appears to have been made to ensure that only the shareholders benefit from the activities funded by the general body of ratepayers.

16. Pacific Bell Directory's accounting and project tracking guidelines and procedures are inadequate with respect to the electronic yellow pages development project. This project and related electronic publishing projects are controversial from a regulatory perspective, especially in view of the fact the research and development efforts started before the lifting of the MFJ information ban. The company did not start tracking its expenditures until the fourth quarter of 1992, approximately six years after the work began. Moreover, this tracking began only after this issue was raised by the Audit Team.

17. There have been no compensation for ratepayers' multi-million dollar risk. Pacific Telesis' electronic publishing ventures have been cross-subsidized by ratepayers.

18. Current affiliate transaction rules may not be adequate to prevent or deter similar situation from occurring. A situation where ratepayers, in essence provide the seed money and bear the risks with the rewards accruing to shareholders.

19. There is presently a proceeding pending before the California Public Utilities Commission in Application No. 93-11-031, dated November 12, 1993, in the matter of the Application of Pacific Bell and Pacific Bell Information Services to notify the Commission to enter Electronic Publishing Service Market, where some of the issues identified in this report are expected to be addressed. Hearings for this proceeding have been scheduled in August 1994.

CHAPTER 2

History of Directory Services at Pacific Bell

The history of Directory Services at Pacific Bell can be highlighted by the following three stages and a discussion of related issues:

- Early years (non-controversial time prior to 1979)

- Transition years (1979: deregulated - 1986: separate subsidiary)
  - From regulated to deregulated (Senate Bill 301 and Senate Bill 1444)
  - From department of Pacific Bell to separate subsidiary (CPUC D.85-12-065)

- Current situation (1987 - present)
  - Stability in the market
  - Possible future services
    - CD-ROM
    - Electronic Yellow Pages

- Related issues
  - Rates for advertising - 10 largest markets
  - Revenue amount imputed over years
  - Legislative hearings
  - Number of communities served and the number of books delivered
  - MFJ history

EARLY YEARS (to 1979)

The following summary of the early history of directory service in California was provided by Pacific Bell Directory in response to a data request.

> "Pacific Telephone's directories were an outgrowth of city directories which were first published in the United States in the latter part of the 19th century. The first white pages directory in California was published by San Francisco in 1878 with 173 residents and businesses. On a single sheet in the "Daily Gossip" you could find a complete listing of every one of the 173 California subscribers to the new service from the American Speaking Telephone Company. Interestingly, there were no numbers then: You

just gave the operator the name of the person or business you wanted to reach.

But even in 1878, what was to one day become Pacific Bell SMART Yellow Pages was the most complete telephone listings of goods and services available. And by 1890, there were so many subscribers that the telephone company started assigning two-to-five digit numbers and a switchboard designation to accommodate the rapidly growing popularity of telephone service.

San Francisco was the major business center in California in the early 1900's. The 1906 earthquake and fire virtually destroyed the city's telephone system. The replacement system greatly improved upon the old one-and the telephone directories improved too.

The rebuilding of San Francisco made it clear that what people needed was a comprehensive phone book that grouped similar kinds of businesses together. This need led to the first advertising directory published by Pacific in 1907. Then as now, directory changes were made in response to the needs of telephone subscribers and to provide high quality product. This gave birth to the first telephone directory classified listings and the first advertising in the directory. Those first enterprising businesses that placed advertising saw their ads on "pink pages". It wasn't until 1916 that the "pink pages" became the yellow pages, when tests at Bell Laboratories proved that writing on a yellow background made reading easier.

In 1926, the California Supreme Court ruled that telephone company directory rates should be reviewed by the Railroad Commission (later called the Public Utilities Commission), and issued a writ of mandate requiring the Commission's response to complaints regarding alleged price discrimination between those who purchased single ads and those who purchased space for sub-dividing and resale. Thus, the age of regulation of directory advertising began.

From 1926 through 1979, Pacific's directory division continued to operate under the jurisdiction of the California Public Utilities Commission. Product changes, such as enhancing or adding new advertising items, changir advertising rates, and making changes to the directory boundaries required Commission approval. It was during tl period that independent (non-telco) publishers began to establish themselves in Pacific's franchise/regulated territory and introduced the competitive yellow pages concept in California. By 1979, there were eight publish producing 265 directories in California, with only 67 of these directories produced by Pacific. In addition to the vast number of directories available, advertising customers had the option of using radio, television, newspapers and direct marketing to deliver their advertising messages. The advertising market had become highly competitive."

TRANSITION YEARS
(1979: deregulated - 1986: separate subsidiary)

This section covers the period of time when yellow pages was transitioned from a regulated to deregulated service in California (SB 301 and SB 1444); and then from being a department of Pacific Bell to a separate subsidiary. (CPUC D.85-12-065)

Legislation

In 1979, Senate Bill 301 authored by Senator Alquist added Section 728.2 to the Public Utilities Code. The bill states in part that:

> "The commission shall have no jurisdiction or control over classified telephone directories or commercial advertising included as part of the corporation's alphabetical telephone directories, including the charges for and the form and content of such advertising, except that the commission shall investigate and consider revenues and expenses with regard to the acceptance and publication of such advertising for purposes of establishing rates for other services offered by telephone corporations."

This bill also had a "sunset date" of January 1, 1983. The statute would be repealed on January 1, 1983, unless a later enacted statute deletes or extends that date.

While SB 301 deregulated directory services, the financial contribution that directory services provided was maintained. Therefore, while regulation over the rates, terms and conditions of telephone directories was terminated with this bill, the contribution was maintained. The bill would remain in effect until January 1, 1983, unless a later enacted statute deletes or extends that date.

In 1982, Senate Bill 1444 authored by Senator Montoya amended Section 728.2 of the Public Utilities Code. SB 1444 deleted the "sunset date" imposed by SB 301. Additionally, SB 1444 created Section 728.2(b) which allowed the Commission the jurisdiction regulate commercial advertising if it determined, after a hearing, that any federal action would impair its ability to investigate and consider the revenues and expenses of directory advertising for the purposes of setting rates for other services. The Commission's jurisdiction would "be limited to the rates and charges for commercial directory advertising, except that the commission shall investigate and consider revenues and expenses of telephone corporations related to that advertising for purposes of establishing rates for other services offered by telephone corporations." The Commission would have no jurisdiction on (i) the form and content of the advertising (ii) the form and content of the directories (iii) directory advertising practices (iv) the determination of the geographic areas served by those directories and (v) complaints by any corporation or person regarding directory advertising.

California Public Utilities Commission (CPUC) Decisions

The following discussion lists some of the major decisions that the CPUC has issued concerning directory services.

D.83-12-018, December 7, 1983:

Pacific Bell filed Application 83-09-19 to transfer its white page and yellow page directory services from applicant to a new company known as PacTel Directory, a proposed affiliated company within the holding company, Pacific Telesis. During the time between the prehearing conference and the hearings, Pacific Bell filed a pleading withdrawing the application without prejudice. (D.83-12-018)

D.85-10-042, October 17, 1985:

Pacific Bell filed Application 85-05-139 to create a subsidiary called Pacific Bell Directory and to transfer its directory properties to that subsidiary. All of the net revenues of Pacific Bell Directory would be paid to Pacific Bell in the form of dividends. Therefore, current revenues from the directory operations would continue to be available to Pacific Bell and would still be considered by the Commission in establishing rates. Pacific Bell cited six reasons to support its request for a separate subsidiary:

A. The nature of the directory business had changed substantially. Other firms compete against Pacific's printed directories already and those firms in the future will compete by providing electronic publications.

B. Pacific Bell's profits from directory business supports basic rates. By separating the directory operations into a stand-along subsidiary, competitive erosion would be more clearly demonstrable.

C. There would be no adverse effect on Pacific Bell, the Commission or the Commission's powers. The stock would be owned by Pacific Bell. The books and records would be open for Commission inspection. Pacific Bell Directory would be subject to all applicable sections of the Public Utilities Code. The revenues and expenses could be considered in setting Pacific Bell's rates.

D. Pacific Bell was concerned that electronic directory publishing would to some extent adversely impact the profits from traditional directory operations reducing the support for basic rates.

E. A separate subsidiary would create specialized management systems that may afford it competitive advantages.

F. FCC and Uniform System of Accounts (USOA) rules were not suitable for a business that provides directory services. Competitors of Pacific Bell's directories used Generally Accepted Accounting Principles (GAAP) for management information and financial reporting. Maintaining two sets of books would be expensive and cumbersome.

D.85-10-042 dismissed Pacific Bell's Application to transfer its directory properties to Pacific Bell Directory (A.85-05-139). The decision cited two reasons for dismissing the application. The first reason was "applicant does not provide sufficient evidence to demonstrate that the transfer of assets and a corresponding venture in electronic publishing will not adversely affect contribution to local rates." The second reason was the "application is vague about its proposed treatment of revenues from its directory services". The decision goes on to state that "we would prefer that electronic services and other viable competitive services be provided through Pacific Bell, rather than a separate subsidiary, to assure that ratepayers benefit from their provision and to reduce the auditing burdens imposed on our staff." [1]

<u>D.85-12-065, December 4, 1985</u>:

Pacific Bell re-applied to transfer its directory properties by filing a Petition for Modification of D.85-10-042. This Petition

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[1] D.85-10-042.

addressed some of the concerns raised by D.85-10-042. Pacific Bell gave three reasons to justify its request to modify D.85-10-042:

1. The MFJ prohibited Pacific Bell from providing electronic publishing services and waivers would not be granted until there had been significant changes in market conditions. Also, Pacific Bell was not presently seeking to enter this line of business.

2. A separate subsidiary was necessary to obtain an expanded print media waiver. Pacific Bell cites a July 26, 1984 decision by Judge Greene that required that the new line of business be conducted by a separate subsidiary.

3. Pacific Bell claimed that it would be required to meet directory competition in order to maintain and increase contribution from directory revenues to support basic services.

On this last point, Pacific Bell contended that competition in directory services was increasing. For support, it cited the increasing number of publishers and directories in California. In summary, Pacific Bell stated that it needed a separate subsidiary in order to qualify for a waiver of the Modified Final Judgement from Judge Greene so that it could meet the competition in directory services. Page four of Pacific Bell's Petition quotes <u>United States v. Western Electric</u>, 592 F.Supp. 846 (D.D.C. 1984) that "Judge Greene required as a condition for all MFJ waivers that the new line of business be conducted by a subsidiary separate from the telephone operating company." A waiver would allow Pacific Bell the opportunity to produce other print media products and thereby reduce its yellow pages distribution costs by spreading the costs to other print products. Pacific Bell claimed that its competitors already had this capability.

D.85-12-065 authorized the transfer of the directory services department to Pacific Bell Directory as a separate subsidiary of Pacific Bell. The decision became effective on January 1, 1986. On this date, Pacific Bell Directory was created.

Current situation (1987 - present)

From 1987 to the present, Pacific Bell Directory provided services in relatively constant environments. For example, in the regulatory environment, the New Regulatory Framework (NRF) decision, as enunciated in CPUC's D.89-10-031, continued